Preserving Assets for the Long-Term: Financial and Legal Considerations

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Approaches to Investing

Two approaches to investing get a lot of play in the popular media: Security Selection and Market Timing. They have two things in common: they require knowledge of the future and they seldom lead to success. No one knows which securities will do well in the coming years. Nor does anyone know when a particular asset class will hit its peak or its low.

Here are two illustrations of the problem with Security Selection and Market Timing:

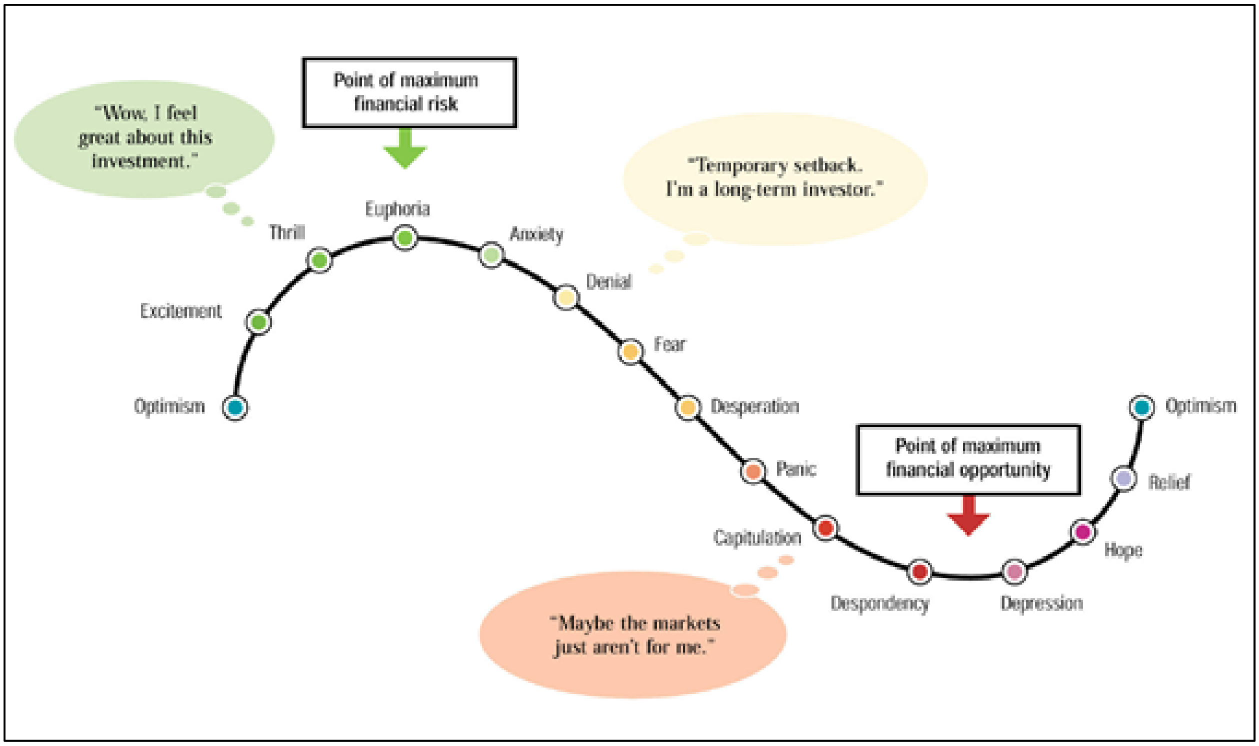
On December 31, 2009, The Wall Street Journal (WSJ) ran an article naming the CGM Focus Fund as the mutual fund of the decade. It had an annualized return of over 18%. However, the average investor in this fund lost 11% annually for the decade. How could this be? This is a volatile fund and had several boom-bust cycles during the decade. Most investors bought the fund when it was performing well. Then, when it lost a significant amount and the typical investor could tolerate no more losses, he or she would sell. Because they were chasing performance, many dollars were invested from high points to low points and far fewer dollars were invested from low points to high points. So, on average, investors lost 11% a year while holding this fund.

Long Term Treasuries were the best performing asset class in 2008 and gained 34% (e.g., symbol TLT). Real Estate was one of the worst performing assets losing 34% (e.g., symbol CSRSX). Looking at their returns at the end of 2008, many investors decided to sell their position in “risky” and poorly performing real estate and put the proceeds into “safe,” long-term US Treasury bonds. What happened? You guessed it. In 2009, long-term treasuries were one of the worst performing asset classes, losing 23%. And real estate was one of the best performing asset classes, gaining 32% for the year.

A Third Approach: Asset Allocation with Rebalancing

Asset allocation with rebalancing is the only proven approach to investing. Asset allocation distributes the portfolio among various investment vehicles such as stocks, bonds, real estate, and commodities. Rebalancing forces you to sell some of the winners and buy more of the losers. Rebalancing helps us to counteract the cycle of market emotions, depicted below.

The Cycle of Market Emotions



We are social animals with a powerful urge to follow the crowd. We want to buy when and what others are buying. Also, we are influenced by the emotions of greed and fear. When we learn that others are making money with a particular investment, greed comes to the forefront, leading us to buy near a market top. And when we lose money, we become fearful that the losses will continue, leading us to sell near the bottom. Investing involves taking some risk, and it is important to know your risk tolerance. If you buy when the market is on a roll and then "panic out" at the bottom, you will not benefit from the growth of the market or a specific security.

Asset Location

Where you place various types of investment will influence your after-tax return greatly. It makes sense to place tax inefficient investments into tax efficient or tax sheltered accounts. Real Estate Investment Trusts, for example, are inefficient from a tax viewpoint, and these should be placed into tax sheltered accounts when possible. Stocks that are going to be held a long time are generally quite efficient from a tax point of view and should therefore be favored as holdings in a taxable account.

Buying Power Over Time

We often talk about risk in terms of ***Loss of Capital***. But ***Loss of Buying Power*** is equally important. For the period of March 2013 through February 2014, the annual inflation rate for the United States was 1.1% and medical care costs rose at an even lower pace. However, we all remember the period of high inflation in the 1970s. With an average life expectancy of at least 80, retirement lasts far longer than it used to. In addition, costs for medical care may be a large proportion of one's expenses. Investing too conservatively may endanger financial security in retirement, as investments may not keep pace with inflation.

Accumulation and Withdrawal

We don't know how long we'll live. If we conserve too much and live a short life, we don't get to enjoy the fruits of our labor and our saving. If we don't conserve enough or spend too much in retirement, we could run out of money during our lifetime. People who are saving for retirement are in the accumulation phase. You want to be sure that your savings rate is such that there will be enough in your savings and investments to retire comfortably, without a decline in your standard of living.

What is a safe withdrawal rate? Researchers like Bill Bengen have devoted a good part of their work to the determination of how much money can safely be withdrawn so that we don't run out during our lifetime. Their research has shown that limiting the withdrawal amount to 4% in the first year of retirement makes it likely that your savings will last throughout retirement. In subsequent years increase the dollar amount withdrawn in the prior year by the inflation rate (historically an average of 3%). If most of your investments are held in a Traditional IRA, another strategy is to withdraw only the Required Minimum Distribution (RMD) each year. For a Traditional IRA, the IRS specifies the RMD based on life expectancy. A difficulty with this withdrawal strategy is that the funds available for living expenses will fluctuate with the value of your portfolio, whereas the 4% rule provides greater consistency.

Summary

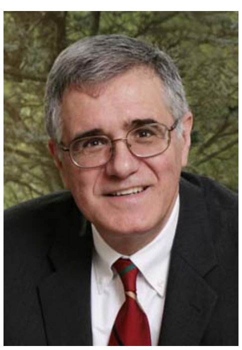
Financial security in retirement is determined by five factors:

Withdrawal rate
Inflation
Longevity
Medical expenses
Approach to investing **(A**sset allocation with rebalancing)

The two factors we can control are **Withdrawal rate** and **Approach to investing.**

Things to think about:

1. Following the 4% rule of withdrawal will increase the likelihood that your money will last throughout retirement.
2. Focusing on a diversified portfolio consistent with your risk tolerance and time horizon is likely to increase your return. Focusing on stock picking and market timing is likely to reduce your return.
3. Taking advantage of asset *location* (as opposed to *allocation*) will increase the value of your portfolio. Placing tax inefficient assets (such as bonds and real estate) into tax efficient accounts (such as Traditional IRAs) is likely to result in more money after taxes.
4. Rebalancing every year adds a percent or more to annual returns. That sounds like a small amount, but with compounding it could double the value of your investments in the course of a lifetime.
5. Even in retirement, a diversified portfolio with some "risky" asset classes is likely to help you keep pace with inflation and enhance your buying power.
6. Assets that are sensitive to interest rates (e.g., bonds) tend to go down in value when interest rates rise and up in value when interest rates go down.



Questions, Comments, Feedback?
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